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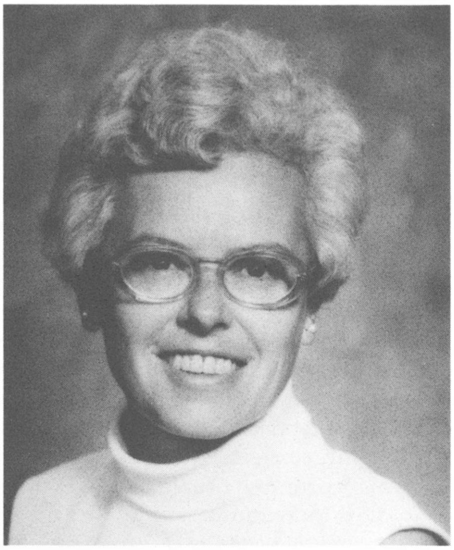

Tax Forum

The Accumulated Earnings Tax Penalty — and How To Avoid It

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Section 531 imposes an accumulated earnings tax on a corporation which fails to distribute its earnings and profits in order to avoid the income tax with respect to its shareholders. The tax, which is punitive in nature, is in addition to the regular corporate income tax and is assessed at the rate of 27½ percent of the first $100,000 of "accumulated taxable income," and 38½ percent of any excess over $100,000. Section 535(c) provides an accumulated earnings credit of $100,000 before the penalty of Section 531 is imposed. This credit is denied multiple corporations formed to avoid tax, and is limited in the case of certain controlled corporations. In arriving at "accumulated taxable income" there are certain adjustments for charitable contributions, dividends received deductions, capital gains and losses and operating losses as set forth in Section 535(b).

To show the effect of Section 531 let us assume a corporation has taxable income of $200,000, pays a regular tax of $89,500, distributes no dividends and has accumulated earnings and profits of $100,000 at the close of the preceding taxable year. There are no other adjustments in arriving at accumulated taxable income. Therefore, 531 tax in the amount of $31,437.50 will be imposed on $110,500 ($200,000 - $89,500) leaving net earnings in the company of $79,062.50. In this example, corporate profits have been taxed away at a rate in excess of 60%.

If we go one step further and assume that the remaining profits are distributed to noncorporate shareholders in the 50 percent tax bracket, another $39,500 in taxes will be assessed at the individual level. The final result is $39,500 of spendable income from $200,000 of corporate profits, or roughly 19½ percent. Had the directors of the corporation chosen to distribute rather than accumulate income, its stockholders could have had $55,250 in after tax dollars.

With the exception of Trico Products Corp. in 1942 (46 B.T.A. 346), the accumulated earnings tax had not been applied to publicly held corporations until it was assessed recently in 1972 against Golconda Mining Corp. (58 T.C. 139). Generally, pressure from stockholders of publicly owned corporations will result in dividend payments that will assure a reasonable balance between funds retained for corporate operating or expansion needs and those made available for distribution to shareholders. It is the private or family corporation with only a few stockholders that is more likely to retain profits in excess of reasonable business needs in order to avoid additional tax at the shareholder level. Although the stockholders of Trico Products Corp. numbered more than 2,000it was rather a hybrid since six controlling shareholders owned approximately 74 to 78 percent of the stock in the years it was held subject to the accumulated earnings tax. For this reason, the court had no difficulty in determining that corporate profits had been purposely retained to avoid additional tax with respect to its controlling shareholders. As a result of this assessment, the other stockholders brought a suit for mismanagement against the directors of Trico who paid the Corporation over $2,000,000 in settlement.

In the Golconda case there was also broad public ownership with between 1,500 and 2,900 shareholders during the period at issue. Unlike Trico, no more than 17 percent of Golconda stock was owned or controlled by its management group. In concluding that a public corporation could be subject to the accumulated earnings tax the court acknowledged that it would only occur "where the fact of public ownership is neutralized by the manner in which the company has been managed." The court enumerated two situations that might possibly "neutralize" the public ownership factor:

1. Domination of management by either one shareholder or a small group with large stockholdings who could exercise effective control over corporate dividend policy.

2. A corporation that represents itself to prospective or existing shareholders as being an investment company with a policy of accumulating its investment income, i.e., a growth company.

In 1966 Golconda used current earnings and profits in redemption of its own stock relative to a merger with Hecla Mining Company. The tax court found that the merger in question was not motivated by the business requirements of the corporation, but was instead accomplished for the benefit of the shareholders. The dominant officer-director-shareholder of Golconda had avoided some $26,000 in individual income taxes and another director more than $11,000 through the corporation's decision not to distribute all of its earnings and profits in 1966. These facts together were considered sufficient evidence to determine that an accumulated earnings tax had been properly assessed for the year 1966.

It remains to be seen whether the Golconda case will provide new vistas for the Internal Revenue Service in the area of Section 531 assessments. This case certainly emphasizes the fact that corporate directors should always weigh carefully the matter of distributing earnings, particularly so, if dominant shareholders will realize substantial benefits from the accumulation of earnings rather than the distribution.

In 1971 the distribution of corporate earnings was curtailed as a result of limitations imposed under wage and price controls. The Service issued Revenue Procedure 72-11 (1972-1 C.B. 732) the following year in which it held that excess accumulations would not be subject to accumulated earnings tax to the extent that earnings could not be distributed without violating dividend guidelines under Phase I and II of the Wage and Price Stabilization Program. In addition, this procedure brought under its "protective umbrella" all corporations not technically subject to the guidelines that also accumulated earnings in order to comply with the spirit of the program. This meant that all corporations who paid out the maximum allowed by the dividend guidelines could accumulate the balance of their earnings and profits with impunity. The present maximum dividend distribution permitted is the greater of (a) 25 percent of the previous year's net income (after taxes and preferred stock dividends), (b) an aggregate cash payment per share that does not exceed the amount allowed in the prior year by more than 4%, or (c) an aggregate cash payment per share that, as a percentage of per-share profits after taxes in the last completed fiscal year, does not exceed the corporation's last five year average payout ratio. The temporary protection afforded corporations not subject to the guidelines has now been revoked by Revenue Procedure 73-33 effective for taxable years ending after December 31, 1973. It is anticipated that before this column reaches print all restrictions on dividend distributions may have been removed, leaving corporations again completely vulnerable to Section 531 attack.

The fact that a corporation has accumulated earnings and profits in excess of $100,000 is not conclusive evidence that income has been retained for the purpose of avoiding tax at the shareholder level. Prior to 1954 a corporation's only defense for retaining excess earnings was to prove lack of intent based solely on the subjective motives of its shareholders. Today, this negative proof or "Subjective test" has been supplanted by the more serviceable "objective test" or reasonable needs, including reasonably *anticipated* needs, of the business (Code Sections 533(a) and 537).

Under the objective method, the capital structure of the corporation should be examined in order to first determine if funds are available for dividend distribution. If the balance sheet indicates that earnings have been invested in plant and equipment and/or are required for the payment of deferred charges there may be no working capital available for distribution to shareholders. Furthermore, Regulation 1.537-2 provides that future needs of the business, i.e., bona fide expansion, plant replacement or acquisitions will support and be considered adequate reason for the retention of earnings. Planning for future requirements should be factual and verified by reference in the minutes of meetings held by directors and stockholders of the corporation. Vague plans for future expansion that never materialize will be of no value in defending a proposed Section 531 assessment.

Working capital required for the normal operating costs of a business has been the focal point of many accumulated earnings tax litigations. In its simplest form working capital is represented by the excess of current assets over current liabilities and identifies the relatively liquid portion of total capital (stock and retained earnings) available as a margin or buffer for meeting obligations within the normal operating cycle of the business. Once working capital has been determined the next step is to compute the operating turnover or cycle formula. This has been developed and offered as a "practical" means of calculating the amount of current earnings a company should retain to meet its day-to-day operations. The operating cycle is generally that period of time required to convert cash into raw materials, raw materials into inventory, inventory into sales and accounts receivable, and the period required to collect outstanding accounts.

The mathematical formula established in the Bardahl Manufacturing Corp. case for measuring the operating cycle of a business has frequently been the basis used in defense of accumulating earnings (T. C. Memo 1965-200). Since operating expense requirements generally vary from industry to industry, modifications are usually required for each individual situation. For example, Bardahl International Corp. tempered the operating cycle formula when applied to a sales corporation by including a credit factor for the time payment period allowed by trade creditors (T. C. Memo 1966-182). The annual cost of goods sold plus total annual operating expenses (excluding depreciation and federal income taxes) is multiplied by the operating cycle percentage to arrive at working capital requirements for one complete operating period. In two later cases following the Bardahl decision a new concept of using peak rather than average requirements for inventory and receivables was introduced, permitting more funds to be retained to cover operational outlay. (Magic Mart, Inc. 51 TC 775 and Kingsbury Investments, Inc. T.C. Memo 1969-205).

Another method for computing the minimum reasonable needs of the business is the use of available liquid capital rather than available working capital. Instead of considering all current assets net of current liabilities as available to carry operating expenses, only liquid assets (cash, marketable securities and other assets readily convertible into cash) are considered currently usable for continued corporate operations and growth. This method employs the cash cycle approach rather than the operating cycle concept in determining reasonable needs of the business.

Cash cycle includes the costs and expenses (net of depreciation) that are expected to be incurred during the procurement and delivery period of corporate operations. Unlike the operating cycle method, the cash cycle does not generally include a collection period, since under normal business conditions the collection period operates contemporaneously with the procurement-delivery period. Available liquid capital is arrived at by deducting from equity capital the amount required to carry noncash assets (receivables, inventories, net plant and equipment, etc.) and adding back capital borrowings represented by current and long-term liabilities. Under the cash cycle approach payments of debt obligations, replacement of maximum inventory, operating and other expenses for one cash cycle (less depreciation) and capital additions in the following year are considered reasonable and necessary for normal business operations.

It should be emphasized that there has been no completely accepted procedure established for computing the operating or cash cycle requirements of a business. Each case will generally stand on the relative accuracy and reasonableness of its own method.

A related problem in the case of a closely-held corporation is financing the payment of death taxes and estate expenses where the bulk of the decedent's assets consists of stock in the family corporation. Unless the estate and heirs have sufficient other liquid assets to pay the taxes and expenses a sale of corporate stock will be necessary in order to provide the cash required. If the corporation doesn't redeem the shares, this situation

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home ownership is generally a good investment. Buying in the right area is a must. As slum areas are being cleaned up, new ones develop; the values in the newly developing slum areas normally drop or at least increase at a pace much slower than in areas away from slums. Get to know the area before you buy so that you do not get into a deteriorating area.

Interest on home mortgages and real estate taxes is currently deductible as itemized deductions for Federal income tax purposes. (Federal income tax provisions are, of course, subject to change.) Depending on your income tax bracket, other itemized deductions and the standard deduction available to you, you could save substantial amounts of federal income tax by owning a home.

The resale market for any home you might consider purchasing should be very important to you. For example, if you buy a house or condominium in a new development which will take several additional years to complete, you should plan on staying for awhile. The resale value will probably rise at a much slower pace while new units are available than after the development is completed. Therefore, if your plans include future moves, consider the timing of those moves in regard to resale of any residence you may purchase. Also, in many areas, condominiums are rather new and a good resale market has not yet been established.

Since an owner is normally responsible for maintenance and repairs, this should be a consideration in your choice. As a tenant, the costs of maintenance and repairs are covered by rent. However, the owner of a number of properties may employ people to do this type of work on a full time or part time basis which should decrease the cost per repair below the cost to a homeowner of a single unit. As an owner, you have the right to improve your home which may be important to you. A tenant normally would not have that privilege.

Like the choice between multi-family or single-family, whether to own or rent requires consideration of your specific situation.

The previous discussion has centered completely on multi-family versus single-family housing and home ownership versus renting; another possibility would be to buy a duplex or small apartment building which combines home ownership with investment. This alternative limits the choice of selection relating to the type of housing and location. If you wish to explore this possibility further, you should be analyzing the investment potential as well as selecting a residence. An investment property may offer a tax advantage due to accelerated depreciation, it may allow payment of the mortgage for the rental unit or units and at least part of your residence from rental income, and it would allow you to keep a close watch on your investment. It could also be a headache to you since the management would be your responsibility. For a fee, probably five to seven percent of rental income, you can hire someone else to manage the property. If you are interested in long range investing and home ownership, this possibility deserves consideration.

In light of the current "energy crisis", there is one other alternative for a living facility which should be discussed. This alternative, with your employer's consent, would be a cot or a sofa in your office. This would be the ultimate in job convenience, and could save a considerable amount of commuting fuel and time. However, it would require some inconveniences when relaxing, entertaining, or sleeping. Your employer may even like the idea as you would be available more hours.

In conclusion, there are several life styles to choose from. Each of us is a unique individual and should consider one's own resources and desires in selecting a home best suited to oneself.

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successful information system. They can facilitate communication among the various divisions of an organization (especially communication between the computer staff and non-computer staff) by providing a common "vocabulary" and method of description, thereby speeding the communication process and eliminating time-consuming and expensive misunderstanding. In addition, adherence to carefully established standards can help simplify personnel training and evaluation.

The amount of documentation and the number of installation standards developed will vary from installation to installation. The size of the installation and the complexity of the processing it does will influence the degree of formality in the documentation and standardization processes. However, every information system should establish those criteria by which its performance will be evaluated, by which it will set its objectives, and by which it will document or record its procedures and accomplishments. Even the smallest installation must have some means by which it can guide its operation and communicate with its users as well as provide a means for modification of its activities and expansion of its applications.

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could result in a forced sale to outsiders thereby causing not only a possible loss of family control, but also a potential financial loss to the estate if the redemption is at less than fair market value.

Code Section 303, enacted specifically to avoid the above result, provides generally that a corporate redemption of stock from the estate of a decedent will be treated as a distribution in exchange for such stock if the value of the shares held by the decedent is either: (1) more than 35 percent of the gross value of the estate or (2) more than 50 percent of the taxable estate. Prior to the 1969 Tax Reform Act, the accumulation of corporate funds to finance such a redemption as a reasonable business need had been both successful (Mountain Steel Foundries vs. Comr., 284 F. 2d 757) and unsuccessful (Dickman Lumber Co. vs. U.S., 355 F. 2d 670) in defending against a 531 assessment. In 1969 Code Section 537 was amended to provide that the "reasonable needs of the business" would include Section 303 redemptions (Code Section 537(b)(1)). At the time the Act was written the Senate Finance Committee Report clearly stated that accumulations in the year of the death and later years to redeem stock in a redemption to pay death taxes should not be considered unreasonable. (S. Rept. No. 91-552.)

Although there are several defenses available for the accumulation of earnings over and above the allowable $100,000 credit, corporate officers and directors would be well advised to document support for such accumulations prior to a proposed Section 531 assessment by the Service. A schedule indicating the present and future requirements for business operations and specific plans for expansion should help avoid the expense and time involved in what might otherwise be a lengthy litigation of the facts.